

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 16707 & 16708
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	

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On May 17, 2002, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (hereinafter referred to collectively as “taxpayer”), reducing the taxpayer’s refund claim for the 1996 taxable year from \$286,426 to \$22,031. On that same date the Income Tax Audit Division issued a second Notice of Deficiency Determination to the taxpayer asserting additional corporate income taxes and interest in the amount of \$65,788 for the 1997 through 1999 taxable years. On July 17, 2002, the taxpayer filed a timely appeal and petition for redetermination relating to both Notices of Deficiency Determination. Those two Notices have now been consolidated for purposes of this administrative appeal.

An informal conference was requested by the taxpayer and was held on October 9, 2003. Shortly after the informal conference was held, the taxpayer provided the audit staff with a federal audit report that had been finalized during the pendency of this administrative appeal. That federal audit report made several adjustments to the taxpayer’s consolidated federal taxable income, which in turn affected the taxpayer’s Idaho income tax liability. As a result of the federal audit adjustments, the Tax Commission’s audit staff prepared a revised audit report dated December 23, 2003, asserting that the taxpayer owed additional Idaho corporate income taxes and interest for the 1996 through 1999 taxable years as follows:

<u>Year</u>	<u>Refund Claimed</u>	<u>Refund Allowed</u>	<u>Tax Due</u>	<u>Interest</u>	<u>Total</u>
1996	286,423	-0-	37,353	22,739	60,092
1997			15,514	6,346	21,860
1998			161,274	53,531	214,805
1999			<u>(33,662)</u>	<u>(8,714)</u>	<u>(42,376)</u>
TOTALS			180,479	73,902	<b><u>254,381</u></b>

The Tax Commission, having reviewed the file, hereby issues its final decision upholding the revised audit report dated December 23, 2003.

### **FACTS AND PROCEDURAL HISTORY**

[Redacted]. is a wholly owned subsidiary of [Redacted]. [Redacted] is a diversified unitary news and information company that publishes newspapers, operates television broadcasting stations and cable television systems, and is engaged in marketing, commercial printing, a newswire service, data services and news programming. [Redacted] has operations in 45 states, the [Redacted], and [Redacted]. The majority of [Redacted] Idaho operations are conducted through two of its subsidiaries: [Redacted]. [Redacted] operates several daily newspapers throughout the United States, including the [Redacted] which is published in [Redacted], Idaho. [Redacted] is engaged in circulation and advertising activities in Idaho with respect to two of [Redacted] nationwide publications; [Redacted]. In addition to these two subsidiaries, there were a handful of other [Redacted] subsidiaries that had a minor amount of Idaho sales during the audit period and one other subsidiary that had a small amount of property located in Idaho.

During each of the years under audit, [Redacted] and the other Idaho nexus subsidiaries of [Redacted] Idaho reporting their Idaho taxable income on a worldwide combined group basis. In October 2000 the taxpayer filed an amended 1996 Idaho return in which it treated the gain on

the sale of its [Redacted] business and certain other assets as nonbusiness income. The 1996 amended return, along with the taxpayer's 1997 – 1999 Idaho consolidated income tax returns, were selected for audit. The Tax Commission's audit staff determined that the gain recognized in 1996 from the sale of the [Redacted] business should be treated as business income. The audit staff also made several adjustments to the taxpayer's 1997 through 1999 Idaho tax returns, none of which are contested in this administrative protest. However, after receiving the Notice of Deficiency Determination relating to the 1997 through 1999 taxable years, the taxpayer asserted for the first time that certain gains and losses that it had reported as business income on its 1997 and 1998 Idaho returns should be reclassified as nonbusiness income. See letter dated December 18, 2002. A worksheet detailing the sales that the taxpayer now claims should be treated as nonbusiness income is attached as Appendix 1.

### ISSUE

The sole issue in this protest is whether the gains and losses from the sale or exchange of certain business assets should be treated as business or nonbusiness income. The taxpayer has asserted that these “nonrecurring” gains did not arise in the ordinary course of the taxpayer's regular trade or business and should be classified as nonbusiness income. In addition, the taxpayer asserts that “[s]everal cases have determined that the sale of an entire business operation generates non-business income.” Letter of protest, p. 1. (citing three court cases).

In a letter dated December 18, 2002, the taxpayer provides a more in-depth discussion of its position:

The gains and losses from certain sales have been treated as non-business income/loss because these sales were liquidations of non-core businesses of [Redacted], and these dispositions (and in many cases, the businesses) were not an integral part of [Redacted] regular trade or business operations. [Redacted] regular trades or businesses have been and still are newspaper publishing and television broadcasting, managed from

[Redacted] headquarters in [Redacted], [Redacted]. The facts related to each non-business item claimed in 1996, 1997 and 1998 are discussed in detail below.

....

Like many other companies who diversified through mergers, consolidations, and acquisitions in the late 1980s and 1990s, [Redacted] fully realized that it would not be successful in effectively managing five different lines of business. Accordingly, along with the expansion of its newspaper and broadcasting operations resulting from the Multimedia acquisition, [Redacted] began to strategically market and sell the assets that were not related to its two businesses: newspapers and broadcasting (which together in 1996 represented approximately 90-95% of total revenues).

[Redacted]'s restructuring involved:

- Refocusing on its flagship newspapers and broadcasting stations, by effectively clustering its properties to take advantage of having newspapers (and broadcasting stations) geographically in close proximity to one another, while acquiring and maintaining desired market areas. [Clustering is to achieve increased advertising.]
- Disposing of certain other lines of business it had previously operated or acquired which did not fit into its core business lines of newspaper publishing and television broadcasting, and for which there was a lack of managerial experience.
- Enhancing and improving the efficiency of the newspaper and broadcasting operations.

Letter of December 18, 2002, pp. 1, 3 – 4 (footnote omitted). In short, the taxpayer is asserting that the gains at issue in this protest resulted from [Redacted] refocusing its overall business operations on its core businesses of newspaper publishing and broadcast television operations. As part of this refocusing effort, [Redacted] sold or disposed of several of its “non-core” lines of business; specifically its outdoor advertising business, a small demographic research company ([Redacted]), a small phone directory business ([Redacted]), and several radio stations that apparently made up its entire “radio broadcasting” line of business. [Redacted] also sold or

exchanged a couple of television stations, two small newspapers, and a cable television system, all of which the taxpayer asserts were no longer material to its refocused business operations. The question thus presented is whether the gain and loss recognized from the sale of these so-called “non-core” assets and lines of business constitutes business or nonbusiness income.

### ANALYSIS

In 1965 Idaho adopted with slight modification the Uniform Division of Income for Tax Purposes Act (UDITPA). That uniform act, as modified, is found at Idaho Code § 63-3027. As described by the Idaho Supreme Court:

The Act contains rules for determining the portion of a corporation’s total income from a multistate business which is attributable to this state and therefore subject to Idaho’s income tax. In general, UDITPA divides a multistate corporation’s income into two groups: business income and non-business income. Business income is apportioned according to a three factor formula, while nonbusiness income is allocated to a specific jurisdiction.

American Smelting & Ref’g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 927, 592 P.2d 39, 42 (1979) (citations to statute omitted), rev’d on other grounds, ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982).

The outcome of this administrative protest turns on whether the gains or losses on those transactions listed in Appendix 1 qualify as “business income” or “nonbusiness income.”

Business income is defined as follows:

“Business income” means income arising from transactions and activities in the regular course of the taxpayer’s trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer’s trade or business operations.

Idaho Code § 63-3027(a)(1). Nonbusiness income is all income other than business income.

Idaho Code § 63-3027(a)(4). The Idaho Supreme Court has recently held that the above quoted

statutory language sets forth two separate and independent definitions of the term “business income.” Union Pacific v. Idaho State Tax Com’n., 136 Idaho 34, 28 P.3d 375 (2001). According to the Idaho Supreme Court, the first definition for business income is “income arising from transactions and activity in the regular course of the taxpayer’s trade or business.” Id. at 38 – 39, 28 P.3d at 379 – 380. In addition, business income also includes “income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer’s trade or business operations.” Id. These two separate definitions are commonly referred to as the “transactional test” and the “functional test.”

The transactional test is concerned with income arising from the ordinary course of the taxpayer’s trade or business, while the functional test is concerned with income derived from property that is utilized in or otherwise directly connected with the taxpayer’s trade or business operations. American Smelting & Ref’g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 931, 592 P.2d 39, 46 (1979), rev’d on other grounds, ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982). Thus, there is no requirement under the functional test that the income arise from transactions and activities in the regular course of the taxpayer’s trade or business. Union Pacific at 39, 28 P.3d at 380. The key determination is whether the acquisition, management, or disposition of the property was directly connected with the taxpayer’s business operations. American Smelting at 931, 592 P.2d at 46 (“business income includes . . . income from tangible and intangible property if that property has the requisite connection with the corporation’s trade or business.”). Property that is not directly connected to the taxpayer’s trade or business operations, such as passive investment property, does not generate business income. As pointed out in the American Smelting case:

In our view, in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and the taxpayer's trade or business. The incidental benefits from investments in general, such as enhanced credit standing and additional revenue, are not, in and of themselves, sufficient to bring the investment within the class of property the acquisitions, management or disposition of which constitutes an integral part of the taxpayer's business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to and connected with the taxpayer's business operations.

Id. at 933, 592 P.2d at 48.

Under Idaho law, there is a general presumption that the business versus nonbusiness income determination of the Idaho State Tax Commission is correct, and the burden is on the taxpayer to establish that the Commission's determination was incorrect. Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984). In addition, the statute itself establishes a strong presumption that income from stock or other securities is business income. Idaho Code § 63-3027(a)(1) ("Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary.") Thus, the burden is clearly on the taxpayer to establish that the gains and losses at issue in this administrative protest are nonbusiness income.

Given that the Idaho Supreme Court has recognized that Idaho's definition of business income includes both a transactional test and a functional test, the taxpayer's claim that the gains and losses from the sale of its assets and lines of business generate nonbusiness income is not very convincing. Under the functional test, it does not make any difference that these were nonrecurring transactions or that [Redacted] is not in the business of selling or trading its operating assets. What is significant is that the property that was sold or exchanged was

acquired, managed or disposed of as an “integral or necessary part[] of the taxpayer’s trade or business operations.”

While conceding that Idaho’s definition of business income includes both a transactional test and a functional test, the taxpayer argues that the functional test should be read to mean that business income includes income from the acquisition, management or disposition of property only where such acquisition, management or disposition constitute integral or necessary parts of the taxpayer’s core trade or business. Letter dated December 18, 2002, p. 8. In effect, the taxpayer asserts that the term “core” should be read into the functional test to modify and further limit when the test will apply.

The Commission is unaware of any authority indicating that the functional test only applies to income relating to the acquisition, management or disposition of a core trade or business. Such a limitation would be contrary to the intent of Idaho Code § 63-3027 to define business income broadly. Absent clear authority to the contrary, the Commission is reluctant to engraft the word “core” into the statutory language of the functional test. In addition, it should be pointed out that Idaho Income Tax Administrative Rule 345.04, IDAPA 35.01.01.345.04 (2003), also cuts against the taxpayer’s argument that only the sale of “core” assets gives rise to business income. According to that Rule, gain or loss from the sale or other disposition of tangible or intangible property is business income “if the property, while owned by the taxpayer, was used in the taxpayer’s trade or business.” So long as the term “used in the taxpayer’s trade or business” is interpreted to mean “directly connected with the taxpayer’s trade or business,” this administrative Rule is consistent with the Idaho Supreme Court’s interpretation of the term “business income” set out in American Smelting. In any event, the Tax Commission is unwilling to ignore the plain language of the statute or to ignore its own administrative rule. As a result,



we hereby reject the taxpayer's invitation to engraft the word "core" into the statutory language of the functional test.

The taxpayer also asserts that under the functional test the gain or loss from the sale of an entire line of business is nonbusiness income. In other words, the taxpayer argues that there is an exception to the functional test relating to the "divestiture of entire lines of business." While this is a relatively common argument, there is nothing in the statutory language, or the Idaho Supreme Court's interpretation of that language, to support such an exception. It is true that a few courts in other states have grafted a "divestiture of a line of business" exception into their business income statutes. See, e.g., McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, 543 P.2d 489 (N.M. Ct. App. 1975); Laurel Pipe Line Co. v. Commonwealth, 642 A.2d 472 (Pa. 1994). But see Appeal of Oryx Energy Co., Cal. St. Bd. of Equal., July 9, 2003 (2003 WL 21693922) (California State Board of Equalization has unequivocally rejected the argument that the functional test contains any sort of "liquidation exception."). It is also true that this specific issue has yet to be addressed by an Idaho court. However, the Commission finds that the taxpayer's claim that there is an exception to the functional test for gains and losses derived from the divestiture of an entire line of business is contrary to the plain language of the statute and is contrary to the Tax Commission's interpretation of the statute set out in Income Tax Administrative Rule 345.04. Absent some competent Idaho authority to support its claim that the functional test does not apply when an asset is sold as part of a divestiture of an entire line of business, the gains and losses from the sale or exchange of the taxpayer's various "non-core" lines of business are business income under Idaho law.

In applying the functional test to the facts in this protest, it is noteworthy that all of the assets and subsidiaries at issue were treated by [Redacted] as part of its unitary business prior to

the sale or exchange of the asset or subsidiary. See Appendix 1, column 4. Thus, the fact that [Redacted]“refocused” its unitary business operations in 1996 – 1999 does not mean that the assets sold or exchanged during those taxable years were not integral or necessary parts of the taxpayer’s trade or business operations in prior years. To the contrary, those assets and lines of business listed on Appendix 1 were clearly treated by the taxpayer as part of its overall unitary business operations prior to the time they were disposed of. The only possible exception is the 1998 sale of [Redacted]. See Appendix 1, reference # 12. [Redacted] is a security business that was acquired by [Redacted] as part of the December 1995 acquisition of [Redacted]. [Redacted]acquired [Redacted]. in order to obtain some strategically significant newspaper publishing, television broadcasting, and cable television operations. In order to acquire these strategically significant business operations, [Redacted] was forced to acquire all of the assets of [Redacted] including an entertainment programming division and the security services division. According to the taxpayer:

[Redacted] acquired [Redacted] to expand its core advertising businesses of newspaper publishing and television broadcasting and to gain entrance into some very attractive market areas for these two businesses. While [Redacted] wanted (and tried via a separate bid) to acquire only [Redacted] newspaper and television broadcasting lines of business, [Redacted]’s Board of Directors refused to segregate the assets and sell the company’s divisions separately due to adverse legal and tax consequences

...

Letter of December 18, 2002, p. 2.

[Redacted] was able to sell off its interest in the unwanted entertainment programming business within a year after it was acquired. The Tax Commission has agreed with the taxpayer that the gain from that sale is correctly characterized as nonbusiness income. The sale of the security services business, on the other hand, poses a more challenging question. [Redacted] did not sell the security services business until March 1998; well over two years after it was first acquired. More importantly, [Redacted] included the net income from the security services business as part of its unitary combined group apportionable business income on its 1996, 1997, and 1998 Idaho group returns; and included the payroll, property and sales from the security services business as part of the combined group denominator on its 1996, 1997, and 1998 Idaho group returns. In addition, [Redacted] treated the gain from the sale of the security services business as business income on its 1998 Idaho group return. See 1998 Idaho corporate income tax return, line 25 [allocable nonbusiness income], and letter from Tax Manager dated 8/13/01 (listing the two transactions included as allocable nonbusiness income on line 25 of the 1998 Idaho return, neither of which was the sale of [Redacted]). It was not until the taxpayer filed its protest of the 1997–1999 Notice of Deficiency Determination that it argued that the gain from the sale of the security services business should be recharacterized as nonbusiness income.

In the final analysis, the Commission finds that there are at least four factors that weigh heavily against the taxpayer's claim that the sale of the [Redacted] stock generated nonbusiness income: (1) [Redacted] owned the business for over two years prior to divesting itself of that line of business; (2) [Redacted] treated the security services business as part of its unitary group in 1996, 1997, and 1998; (3) [Redacted] treated the gain from the sale of the [Redacted] stock as business income on its 1998 Idaho return and only challenged that characterization after

receiving a tax deficiency notice relating to other (now conceded) audit adjustments; and (4) under Idaho's law there is a strong presumption that the gain from the sale of stock is business income. Given all these factors, the Tax Commission finds that the taxpayer has not met its burden of proving that the gain from the sale of the security services stock was nonbusiness income.

In summary, the Commission declines to interpret the functional test to apply only to income from the acquisition, management or disposition of property where such acquisition, management or disposition constitutes an integral or necessary part of the taxpayer's core trade or business. In addition, the Commission disagrees with the taxpayer's contention that Idaho's version of the functional test contains a "divestiture of entire lines of business" exception. Finally, in applying the functional test in a manner consistent with Income Tax Administrative Rule 345.04 and with American Smelting & Ref'g Co. v. Idaho St. Tax Comm., the Commission finds that all of the gains and losses at issue in this protest relate to property and subsidiaries that were acquired or managed as an integral or necessary part of the taxpayer's trade or business operations and were directly connected with the taxpayer's unitary business operations. As a result, the gains and losses all constitute business income.

### **ORDER**

WHEREFORE, the revised audit report dated December 23, 2003, is hereby APPROVED, AFFIRMED AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayers pay the following taxes,  
penalty and interest:

<u>YEAR</u>	<u>TAX (REFUND)</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1996	\$37,353	-0-	\$23,223	\$ 60,576
1997	15,514	-0-	6,547	22,061
1998	161,274	-0-	55,620	216,894
1999	(33,662)	-0-	(9,150)	<u>(42,812)</u>
TOTAL DUE				<u>\$ 256,719</u>

Interest is calculated through March 31, 2004, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2004.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

#### CERTIFICATE OF SERVICE

I hereby certify that on this \_\_\_\_ day of \_\_\_\_\_, 2004, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.